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DEPT FOR SCA/FO, SCA/RA, AND SCA/A
DEPT PASS AID/ANE
DEPT PASS USTR FOR DELANEY AND DEANGELIS
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DEPT PASS TDA FOR STEIN AND GREENIP
USOECD FOR ENERGY ATTACHE
CENTCOM FOR CSTC-A
NSC FOR JWOOD
TREASURY FOR MHIRSON, ABAUKOL, BDAHL, AND MNUGENT
OSD FOR SHIVERS
COMMERCE FOR DEES, CHOPPIN, AND FONOVICH

SENSITIVE

SIPDIS

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TAGS: EFIN ECON EAID PREL IMF AF
SUBJECT: IMF AND AFGHANISTAN AGREE ON TERMS FOR COMPLETING THE FIFTH REVIEW; BALL IN AFGHANS' COURT

REF: A) State 7480 B) 08 Kabul 3277

¶1. (SBU) Summary. IMF staff have reached agreement with the Afghan government and central bank on the terms for recommending Board completion of the delayed fifth review under the PRGF program. The revised revenue target for the fiscal year ending March 21 is $800 million. The government must fulfill three prior actions related to fiscal policy before staff will seek Board approval. If it does so by March 21, the Board can complete the review by late April, and Afghanistan's IMF program will be back on track. If it does not meet these conditions by June, this program would be irreparably off track, and the Fund would not negotiate a new program until after presidential elections in August. In that event, HIPC debt relief would be delayed, and World Bank budget support could be suspended. IMF staff forecast a recovery in economic growth in 2009-10 but remain very concerned about Afghan fiscal performance. The ball is now in the Afghans' court to rescue this IMF program through structural reforms and fiscal discipline.

¶2. (SBU) IMF staff have reached ad ref agreement with the Afghan Ministry of Finance and central bank on the terms for recommending Board completion of the delayed fifth review under the PRGF program. Staff said they remain concerned about slippage in Afghan fiscal performance that necessitated revision of some program targets. But they noted that revenue collection had improved in December-January, compared with the rest of this fiscal year. Key parameters are as follows.

KEY PARAMETERS

¶3. (SBU) Revenue targets. The revised domestic revenue target for FY 2008-09 (ending March 21) is Afs 40 billion ($800 million), down from the original program target of AFs 44.5 billion. The agreed FY 2009-10 target is Afs 51 billion, a 28 percent increase on the revised 2008-09 target. IMF staff called both targets "ambitious but realistic."

¶4. (SBU) Prior actions. The GIRoA must meet three prior actions before staff will recommend completion of the review: 1) it must prepare audited financial statements for electric utility DABM for 2006-07 and 2007-08; 2) it (or Parliament) must pass tax law amendments to impose the business receipts tax (BRT) on imports

(Note: the lower house has passed these and they are now with the upper house); and 3) it must implement the MOU between the Finance and Commerce ministries on Customs access to the FLGE fuel import depot at Hairatan. IMF staff said (on February 2) MOF had assured them the GIRoA intends to implement the MOU in its current form "next week." They said they had no information about earlier indications from MOF that MOCI wanted to renegotiate the MOU. (Note: MOF Deputy Minister Sabit told USG visitors February 10 that the issue had gone to the President, who supported MOF's position that the MOU should be implemented in its current form and not be renegotiated.) Fund staff said they also hope Customs will extend its control at Hairatan to include the privately-owned fuel depots, though this is not included in the MOU.

¶5. (SBU) Other benchmarks. For the sixth review, the GIRoA must verify that it is collecting BRT on imports. Other structural benchmarks will be added for a seventh review to be added to the program (see below) and will be decided on at the time of the sixth review.

¶6. (SBU) Economic growth. IMF staff expect real GDP growth in 2008-09 of 3.4 percent, unchanged from their December forecast. The sharp deceleration compared with last year is due to a 21 percent drop in agricultural production, in turn caused by last winter's drought. For 2009-10 the Fund forecasts 9.0 percent growth, up from their December forecast of 7.7 percent. Staff expect 17 percent growth in agriculture next year based on recent winter precipitation rates near Afghanistan's historical average. They said the GIRoA forecasts real GDP growth of 12 percent for 2009-10, but the Fund is taking a more conservative approach for now.

¶7. (SBU) Revenues/GDP. The new revenue targets and GDP forecasts

imply operating revenue/GDP targets of 6.6 percent for 2008-09 (compared to an original program target of 7.0 percent) and 7.3 percent for 2009-10. These ratios remain among the lowest in the world.

¶8. (SBU) Monetary policy. Fund staff said the central bank will meet the 2008-09 target for growth in currency in circulation of 31 percent. Since inflation has moderated, and in hopes of locking in lower inflation, the bank has adopted a target of 16 percent in 2009-10.

¶9. (SBU) Inflation. Staff said they now forecast end-March 2009 (over March 2008) inflation of 13 percent, down from their forecast in December of 19 percent. Average full-year 2008-09 inflation is estimated at 28.4 percent. Average full-year 2009-10 inflation is estimated at 6 percent. The rise in inflation last year and its ongoing moderation now mainly reflect global factors.

CONTINUING CONCERNS ABOUT FISCAL PERFORMANCE

¶10. (SBU) Despite the agreement described above, IMF staff remain very concerned about Afghan fiscal performance. They said the GIRoA could not adequately explain the very recent improvement in customs receipts; Fund staff are concerned it might not be sustainable. Longer term, they said that on current trends and even with bold new revenue measures, the GIRoA would not cover its operating budget by 2013, the target date in the ANDS, i.e. there would be a significant postponement of even this limited measure of fiscal sustainability.

¶11. (SBU) The main problem with revenue generation, they said, is not technical, but corrupt diversion of resources - what the mission chief called the "infrastructure of leakage." A related factor is weak capacity in the Afghan Customs Department, despite having received much foreign technical assistance. One bright spot is the extension of ASYCUDA to more customs office locations; the IMF has urged its further extension to more border crossings, though this is not a program condition. Staff also stressed the importance of a comprehensive border management plan that clearly defines the roles and responsibilities of all actors and brings all the donors and Afghan organizations together to improve management. They urged donor support for this objective.

¶12. (SBU) Regarding tax obligations by commercial airlines (Ref B), IMF staff said all airlines except one are current, and they have been assured that the delinquent payer would pay back taxes in installments. The ad hoc committee that has recommended tax relief for airlines is still active but it lacks any legal basis and its proposals have not been accepted. In a separate meeting, then-Acting Transport Minister Zakhilwal told EconCouns January 24 that he does not support these recommendations and they will not be adopted.

¶13. (SBU) Fund staff said the GIRoA had internalized the revenue constraint on the spending side of the FY 2009-10 budget now before Parliament. Not counting possible extra security-related spending, domestically financed spending is set to increase by the rate of real GDP growth or perhaps less. Cash balances throughout 2009-10 will remain very tight, and there is no margin for any exogenous shocks. There will be essentially zero domestically financed development spending.

TIMING GOING FORWARD

¶14. (SBU) IMF staff have urged the GIRoA to fulfill the three prior actions by March 21, but this is not a firm deadline. If the government does meet these conditions by then, the Board could consider the review by late April. The GIRoA would also ask the Board to approve extension of the PRGF, probably until March 2010. Under this scenario, the earliest Afghanistan could reach HIPC completion point would be September 2009, i.e. after six months of good performance under the PRGF and at the time of the sixth review.

¶15. (SBU) If the GIRoA does not fulfill the prior actions in time for Board review by June, the PRGF would officially expire. Staff say they would have to negotiate a new program, but a staff monitored program lasting 6-12 months would probably precede a full program. In any case, they would not want to negotiate with the current government so soon before the presidential election, now scheduled for August. Any negotiations on a new IMF program would thus be delayed until after a new government has taken office after the election. Action on HIPC completion point, affecting more than $1 billion in promised debt reduction, would also be delayed by at least 1.5 years. A delay in HIPC would also affect the Paris Club agreement, which expires end-March 2009; absent extension, Afghan interest payments could come due in April 2009. Expiration of the IMF program could also halt budget support from some donors, e.g. the World Bank.

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